COST-OF-LIVING ADJUSTMENTS

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UNITED STATES SENATE

July 10, 1984

The protection of purchasing power in retirement has become the subject of increasing attention during the last several years. Inflation is obviously the direct cause of that attention. But there are other demographic, social and economic factors which have enhanced its importance.

- The trend towards earlier retirement lengthening the payout period over which inflation is a factor.

- Continued advances in life expectancy also adding to the length of the payout period.

- The high cost of medical care at the older ages.

- The difficulty of saving for retirement during inflationary periods, and, when savings can be accumulated, the difficulty of investing at rates that will keep up with inflation.

For an employer intent on providing post-retirement income protection, there are two basic issues:

First, setting the benefit objective - deciding in effect, how much protection should be provided. And second, choosing the approach for delivering that benefit objective.

Setting the benefit objective

Defining a policy for post-retirement benefit adjustments involves the same basic considerations that apply in setting the initial benefit level: income adequacy; employee needs and expectations; equity among employees and the consumers who are charged for the cost of benefits; competitive pressures; productivity objectives; and available financial resources.

Adequacy, in the context of post-retirement benefit protection, is related to the adequacy of the benefit level at the point of retirement. If the initial retiree benefit is large in relation to the initial retirement income objective, a certain amount of inflation protection is built in. If, instead, it is below the initial income objective, post-retirement protection becomes even more important.

In evaluating adequacy, it is also important to consider Social Security and the portion of total retirement income it provdes; Social Security is fully indexed to inflation. Thus, an employee who receives one-half of his or her income from Social Security, has 50% of lost purchasing power replaced by Social Security alone. To protect such an employee against 75% of lost purchasing power, plan benefits need only be adjusted by half the rate of inflation; again, because Social Security is fully adjusted. Consider the following example: The inflation rate is 10%.

		After One Year	
	Initial Income	No plan adjustment	Plan adjustment equals 50% of inflation rate
Plan benefit	$ 5,000	$ 5,000	$ 5,250
Social Security	5,000	5,500	5,500
	$10,000	$10,500	$10,750
Lost purchasing power		$ 1,000	$ 1,000
Total post-retirement supplement as a percent of lost purchasing power		50%	75%

Social Security represents a varying proportion of total retirement income. It is often the major source of retirement income for the lower paid. But it represents a very small proportion of total retirement income for the higher paid. That makes it difficult to design a post-retirement adjustment formula for a retirement plan which works equally well at all income levels. It may be said that higher income employees require larger post-retirement supplements from their retirement plan because the full indexing of Social Security does little to replace their lost purchasing power. However, most employers feel an obligation to protect that portion of income that is used for essential expenditures. This implies greater adjustments at lower-income levels.

Finally, a decline in income over the period of retirement does not, by itself, imply declining living standards. There is a question as to whether or not an individual has constant needs during the period of retirement in real dollars. There is a trade-off between declining expenses because of the retiree's increasingly sedentary lifestyle and the increased cost of additional care and medical expenses as the retiree's physical condition deteriorates. The trade-off will vary for individual people. Studies done so far, focusing on expenditures during the period of retirement, are inconclusive. Expenditures are to a large extent, a function of income rather than a function of need.

In practice, to date most employers in the private sector have been adjusting pension benefits after retirement at the rate of 50% to 80% of the rate of inflation, after taking into account the full indexing of Social Security. In the public sector, the range of adjustments is greater. Many pension plans call for an automatic adjustment at some modest level such as 2% or 3% per year. Others - a declining number - fully adjust for increases in the CPI, like Social Security. Still others, the growing majority, adjust on an ad hoc basis ranging from 50% to 100% of the rate of inflation. Few public employers recognize the full indexing of Social Security in setting their plan adjustments.

Finally, some public plans call for an automatic adjustment to benefits based on the excess of investment earnings over some stated rate.

The benefit objective for adjustments after retirement can take several forms.

It can be:

- Related directly to the inflation rate - such as a percentage of the increase in the CPI. This has traditionally been the most common approach to providing supplements, particularly when the ad hoc approach is used.

- A fixed integrated percentage increase per year, such as 3% on the benefit up to $6,000 and 6% of the excess.

  By integrating the benefit increase with a higher adjustment on income above a certain level, purchasing power is protected somewhat more evenly at various income groups. An example of this approach would be to provide adjustments of 3% of the original plan benefit up to $6,000 and 6% over $6,000.

- Catastrophic protection - that is, increasing benefits by the rate of inflation in excess of a specified percentage, such as 3% or 5%.

  Catastrophic protection assumes that the retiree can absorb or may be expected to absorb, some level of inflation through personal savings or reduced expenditures. This is an approach which may be effective for sporadic, short-term high rates of inflation. It is less effective when moderate rates of inflation continue over an extended period.

- A fixed flat percent per year, independent of the actual inflation rate, such as 3%, perhaps with some maximum dollar increase.

  A flat percentage increase per year has the advantage of having a known cost for the employer. However, since it is not related to the rate of inflation, it may prove overly generous in periods of low inflation and insufficient in periods of high inflation.

- Under a defined contribution approach, the amount of annual increase that can be purchased with a specified dollar amount.

Approach for delivery of benefit objective

Post-retirement supplements can be provided on an ad hoc basis, through a defined benefit plan, a defined contribution plan or with a combination of these approaches. The approach used is to some extent related to the form or formula for the adjustment and to a lesser extent to the approach used to deliver basic retirement income.

Ad hoc approach

The ad hoc approach is one that leaves open the decision to provide post-retirement supplements. This does not necessarily imply the absence of a policy for making adjustments. Rather, it represents the absence of a formal commitment to benefit increases. Almost all employers in the private sector have chosen to provide for benefit supplements to their employees on an ad hoc basis. The adjustments are customarily related to the inflation rate and made either at specific intervals, such as every two or three years, or after accumulated inflation has reached a certain level, such as 25%. While many pension plans covering public employees call for automatic cost-of-living adjustments at some level, ad hoc adjustments are also common.

Providing retirement supplements on an ad hoc basis has several advantages for the employer:

1] Flexibility

The employer retains control of the amount and timing of the supplement.

2] Predictability of cost

The adjustment can be made after the cost impact is known.

3] Public relations value

The employer gets credit for each adjustment as a benefit increase.

However, if adjustments are made on an ad hoc basis, employees have little security that their retirement income will be protected in the future. Moreover, to the extent that employee expectations are raised, the flexibility of the employer to reduce or eliminate adjustments is limited.

Defined benefit approach

A defined benefit approach - one that provides a stated formula for post-retirement benefit adjustments - provides the surest means of meeting a stated benefit objective. That has some distinct advantages for the employers and employees. It also has some disadvantages. It commits the employer to the cost of benefit increases, the amount of which are to a large extent uncertain.

However, the formula for the adjustment can be defined to limit the uncertainty and financial impact of the increase. The post-retirement adjustment formula could, for example, be 3% per year up to a maximum of $2,000, or 3% on the first $20,000 of benefits. Or, it could be related to the increase in the cost-of-living with a fixed maximum of, say 3%.

If the supplement is defined as a fixed annual rate, costs can be calculated with relative certainty. If the adjustment is related to the rate of inflation, to a limit, the maximum cost can be determined with relative certainty.

If the rate of inflation over a period is such that the guaranteed defined benefit adjustment is not sufficient, further supplements could be provided as needed on an ad hoc basis.

Defined contribution approach

Post-retirement protection could be provided through a defined contribution approach as a part of a basic defined contribution retirement plan or as a separate "post-retirement protection" plan. It could involve financing entirely by the employer, or require a combination of employee and employer dollars. In the public sector, where indexing is widespread, contributory plans are common. Though uncommon in the private sector in the traditional form, savings or thrift plans in which companies' dollars are related to employee contributions are gaining rapid popularity.

At retirement, an employee's accumulated contribution account could be converted into an increasing annuity related to his or her retirement benefits.

Under this approach, the employer's fixed cost commitment is limited to its fixed or matching contribution under the savings plan.

The employee, on the other hand, assumes the risk of an inadequate retirement subsidy from two sources.

First, if inflation is high during the contribution period, the contributions made on early career salaries will have relatively little value in relation to final earnings. Second, if inflation is high during retirement, the annuity will be inadequate.

A savings plan arrangement also has some general shortcomings:

- Additional recordkeeping and administration is required.
- The size of the adjustment the account can provide varies greatly by length of service.
- It cannot take care of employees already retired and can do very little for those close to retirement. Continued ad hoc adjustments are necessary for some time.

If investment return is approximately equal to salary growth over the period of the employee's participation in the savings plan, a 4% total contribution [employee plus employer] will produce an account at retirement which is equal to one times final salary after 25 years. That account will provide a 3% COLA beginning at age 65 on a retirement benefit, exclusive of Social Security, equal to 40% of final salary. After 35 years, the amount in the savings account will provide a 4% COLA.

Combined approach

It is possible to take advantage of the positive features of all the strategies discussed previously in a combined financing strategy.

As an example:

A savings plan approach can be used as the basic mechanism for increases in the long-term future. But, the accounts will produce very little for those retiring during the next 20 years or so. This short-term inadequacy could be filled by a defined benefit guarantee. That is, a defined benefit pension plan could guarantee an annual increase of say 4% per year. If the adjustment supported by the savings plan is less than 4%, the pension plan could make up the difference. After one generation, the savings plan will produce higher adjustments and little or no benefits would be needed from the pension plan.

Finally, if the savings plan or defined benefit guarantee is not sufficient during periods of high inflation, additional supplements could be provided on an ad hoc basis.

Table I

ADVANTAGES and DISADVANTAGES of ALTERNATIVE APPROACHES

	Ad Hoc Adjustments	Defined Benefit Approach	Defined Contribution Approach	Combined Approach
ADVANTAGES	Flexibility is maintained. The employer decides when and if increases will be granted. The employer gets credit for each adjustment	The benefit is defined and assures a basic level of protection	The cost is certain and contained and may, in part, be shared by employees Defined contribution plans are popular among employees because the additional employer contribution is immediately visible in their accounts rather than in the form of a deferred promise.	The cost is contained and shar in part, by employees. A guaranteed benefit is define and assures a basic level of protection. Defined contribution plans are popular among employees.
DISADVANTAGES	Employees have little security that their retirement income will be protected in the future. The cost of benefits for current employees is shifted to the next generation. Benefit levels need to be reviewed frequently.	If benefits are a function of future salary levels, the cost is uncertain. The employer is committed to a benefit that it may ultimately be unable to afford.	The benefit supportable cannot be defined in advance. The employer will be committed to a contribution which it may ultimately be unable to afford. The need for ad hoc increases will continue until substantive contribution accounts accumulate.	If a function of future salary levels, the cost is uncertain. The program may be complicated and difficult to communicate. With high inflation rates, employees may reject the guaranteed increase as insignificant, or may consider the required contribution too high for the benefit purchased.